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ABSTRACT

The origin of deregulation of higher education in Colorado, its effects, and implications for other states are discussed. In "How and Why It Happened," Thomas G. Tancredo traces the development of a new budgeting process, called MOU (memorandum of understanding). Under MOU each governing board is responsible for setting the expenditure level for institutions, setting tuition policies, and retaining and expanding all cash revenues generated at the institutions. State appropriations are based on general-fund support per full-time equivalent student. Tension in legislative-institutional relations was one reason for the change. In "Deregulation's Effects--and Defects," Marilyn McCoy sees efficiency as a potential result of providing incentives and delegating authority and responsibility to college officers and board members. One disadvantage is that the state can impose pay increases for staff without having to pay for them. Finally, in "Lessons from Colorado," Patrick M. Callan explains his reactions to the Colorado experiment. He sees a combination of flexibility and control in the model. The issue is whether this new system has the mix of incentives that, over the long term, produces institutional responsibility and serves enduring public interests. (SW)

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STATE DEREGULATION AND MANAGEMENT FLEXIBILITY

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You've read about "deregulation" and seen its effects on banking and air travel. What if the concept were applied to higher education? In fact, Colorado has been at it since 1981. Here's how and why it came about, a look at the effects, and what it implies for other states.

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1. How and Why It Happened

by Thomas G. Tancredo

In 1981, Colorado set in motion a revolutionary process of budgeting that has come to be known by the initials of its key document, "MOU." MOU refers to a Memorandum of Understanding developed between the state and the several boards that oversee Colorado public higher education. The MOU sets in place four key principles:

(1) Each governing board has the authority and responsibility for setting the expenditure level for each institution under its jurisdiction. So the state's community college board, for example, now has final say on what each individual community college may spend in a given year.

(2) State appropriations are based on general-fund support per FTE student. In the past, each institution would have an appropriation from the state that might entail 50 line items; that's been reduced to one line. And given principle #1, each governing board may transfer funds from its overall appropriation among the colleges within its jurisdiction as it chooses.

(3) Each governing board has responsibility for setting tuition policies in its institutions. The legislature is out of the tuition-setting business. One former proviso remains, that non-resident tuition be at least three times that for state residents.

(4) Each governing board is now able to retain, expand, and roll forward all cash revenues generated within their institutions. A college that saves a dollar and earns interest on it doesn't have to send its accumulation back to Denver on June 30.

A Time for Change

At the time of these changes, I served as a state legislator and chaired the Colorado Joint Budget Committee, which is the budgeting arm of the state. It was within this committee (and not an education committee) that the MOU came forward. Three factors seemed persuasive to us in the legislature as the concept of the memorandum began to take shape.

First, timing is everything in politics, and the times were ripe in Colorado for change in the relationship between state government and higher education. There had been years of wrangling between the legislature and the executive and the higher education community over the budgeting process. We'd just been through a horrible period during which legislators had it in their heads that productivity in higher education could be increased by developing some sort of a productivity formula; there was also a complex funding formula proposed by the presidents that I don't think anyone really understood and that left everybody confused and frustrated. The colleges were angry and the legislature wasn't very happy either.

The MOU came forward, then, as a simplification of matters and a device for peace. Presidents started telling their representatives that they thought they could live with the new set of rules. A lot of bar-

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gaining was done in a series of caucuses, so that when this whole great change came to the floor, instead of the all-night debate I was prepared for, in three minutes somebody said "I move the question . . ." and that was the end of it.

A second sense that took hold in Colorado was destruction of what I call the "illusion of oversight." For years, legislators had been told that we had a solemn responsibility to maintain something called "oversight" of the higher education enterprise in the state. I had heard it for years, from important people, especially when I served on the House education committee. As the years passed and I observed what happened, though, I realized that oversight never effectively occurred at the legislative level. Some legislative staff, perhaps, exercised some degree of oversight over some aspects of the budgeting process. But legislators themselves in reality never had the time to comprehend the entire pattern of higher education programs in the state, the fullness of its budget, the complexity of its management, the various board-led forms of its decentralized governance. If a few understood at least some of these things, even fewer really cared about them, but everybody had been told they had a responsibility and, therefore, wanted to hang on to elaborate forms of control.

I don't think the state has its incentives in order in the whole realm of tuition-setting, out-of-state students, and financial aid.

It took a very long time, and a lot of cajoling, before I could dislodge my colleagues from that position. But it was a central illusion to dislodge before the kinds of changes contemplated by the MOU could be considered.

A third factor I'd mention also entailed a new way of looking at things; its source was cultural, not personal. That is, a philosophy of decentralization has come upon us. People read *Megatrends* or Peters and Waterman and got the idea that bureaucracy and centralized management are bad. So it became easier to encourage legislators to think about giving governing boards a chance to manage. What were board members elected or appointed for? Let's get the ball out of our court and into theirs. Let's give them some responsibility here.

Observing Results

Since I work for the federal government now, I'm outside the daily process of implementing the MOU, but I've been an observer of it. My sense is that it has increased a drive for excellence in higher education. I think that institutions are being much more creative in the way they address the educational marketplace. Programs are more likely to be developed on the basis of need. There is a degree of competition that I really like. A place like the University of Northern Colorado, which has had its share of trauma from declining enrollments and some bad publicity, has been able to reallocate resources and see light at the end of the tunnel because it had the management flexibility to address its situation and take appropriate steps.

I can't tell you everybody is in love with it. The Board of Agriculture, which governs Colorado State University, refused to sign the MOU this spring. OK, state officials said, we'll develop a budget for you, 51 or 52 line-items long. There was a lot of back and forth, and some anger, before the Board finally signed back on for the year.

Some educators still resist the concept because they perceive it as a mechanism for reduced funding, the way block grants at the federal level have been associated with net reductions in funding levels. My own opinion is that these have been times of reduced resources all around, and that funding would have been cut whatever funding mechanism had been in place. Given tight resources, it's all the more important to have a mechanism that gives people on campuses the management flexibility to use best the scarce resources they have.

A more real problem is this: while the MOU unchained institutions on the funding and expenditure side, it left in place certain mechanisms that tie schools up on the costs side. A big part of their costs are for personnel, for example, and a large portion of their work force remains in the state personnel system. That system mandates a big pay hike and the institutions have no choice but to go along whether or not they get the money for it from the state. My solution was to take higher education out of the state personnel system, but not many people were ready to cut that umbilical cord.

Another problem is that the legislature has insisted on keeping caps on the enrollment of certain institutions. This makes no sense if you're talking about management flexibility and a free-market mode of operation. Also, though I'll leave more on this point to my colleagues on the panel, I don't think the state has its incentives in order in the whole realm of tuition-setting, out-of-state students, and financial aid.

There's one last problem in the system, though I still think it's a good one: there's a destabilizing element in the picture because of the transient composition of the legislature. Elections and people come and go, and so many of the legislators who understood the MOU at its enaction are now gone that the whole process seems to start over every year. The legislature's institutional memory is thin. I read the newspaper and see the same issues being raised now that we all thought had been settled earlier.

How to Do It

The questions I get from legislators in other states usually are of two types. First, what did you and your colleagues do to get this passed? Second, how has it worked out? I've taken my cut here on the second question, and Marilyn McCoy and Pat Callan will fill out that picture for you. Let me conclude by saying more, from a legislator's standpoint, about how this change developed.

It was a great help, as I mentioned earlier, that certain conditions existed: unwanted tension in legislative-institutional relations, a sense that oversight was an illusion, and the idea that centralized management was bad. There are some other things of a practical na-

ture that turned out to matter:

- the budget agency. Colorado may be unique in having its budgeting function lodged in the legislature; usually it's an executive function. Either way, the key people in your state who do the budget have to buy into the process.
- the higher education community. It was important to have some kind of consensus across the governing boards and institutions that this was a good step, and then to have educators themselves tell legislators that this was the way to go.
- a trusted arbiter. We got that consensus in part through the good offices of the Colorado Commission on Higher Education and its executive director, Dr. Lee Kerschner. In the negotiations that preceded the MOU, we needed a go-between, an arbiter, an agency the legislature thought was on "our side" and that also had credibility in the higher education community.
- media support. I had several meetings with the editorial staffs of the two major newspapers in the state, and a great series of editorials resulted. My colleagues in the legislature paid more attention to those editorials than they did to my cajoling.
- a pilot program. To get people used to the idea and show that evil does not surely follow, it helped in Colorado to try it out in an institution. We piloted the idea at the Colorado School of Mines (where we knew it should work), then were able to come back to our colleagues in the legislature and say, "Look, it works. Let's try it on the whole shebang."

Two final understandings were necessary in the legislature, both of a practical nature. One had to do with financial aid. If you're going to let tuitions float, to be set by individual boards or institutions, they'll likely go up by more than the legislature itself would vote. That will increase, beyond legislative control, the aggregate need for student assistance. So the student-aid commitment so necessary to access had to be there.

Second, if the incentives are for entrepreneurial activity, the legislature can't get upset the first time it sees ads in the papers or on TV soliciting students to enroll. If you want free markets and a measure of competition, then you should expect efforts by institutions to make themselves visible in the marketplace.

2. Deregulation's Effects—and Defects

by Marilyn McCoy

The central issues in the regulation/deregulation debate were well captured, in my judgment, in a recent book edited by James Mingle in which he argues,

"States are faced with this choice: they can try to force productivity improvements through regulation and control or they can try to encourage efficiency by providing incentives and delegating authority and responsibility to institutional officers and board members.

"States that choose to regulate their institutions closely may capture savings in the short term, but they are likely to dampen the initiative, imagination, and motivation of individual managers to make long-term improvements in productivity."[1]

This statement frames the issue of governance in terms of control vs. incentives. Until the MOU, the orientation of the legislature was for detailed "control" of institutional revenues and expenditures. This changed with the introduction of the MOU when institutional governing boards in Colorado were given the authority to establish tuition and other price levels; retain all collected tuition revenues, indirect-cost recoveries, gift monies, and the like; and roll forward funds into the next fiscal year. On the expenditure side, boards obtained the authority to allocate funds to areas of perceived relative priority based on the judgments of operating managers rather than a distant legislative staff.

The incentives created by these shifts are substantial and important. Institutions are now encouraged to expand their non-state revenue sources through improved gift solicitation, increased external research support, more effective tuition pricing strategies (as contrasted with formula-driven approaches previously in place which ignored market and comparative conditions), and better cash management (such as more prompt tuition collection and better receivables control).

Positive incentives are evident on the expenditure side as well. With the capacity to carry forward funds year-to-year, incentives for year-end spending and inventory building are countermanded by the interest-earning capacity of funds.

Longer-term cost savings, such as energy retrofits or computing and communications systems improvements now are encouraged since institutions know they can retain the savings over the years. With the MOU, expenditure patterns can become more rational as

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[1] Mingle, James R. editor. *Management Flexibility and State Regulations and Higher Education*. Southern Regional Board, Atlanta, 1983, p 12.

individual unit managers have the opportunity to decide on a relative basis their most important expenditure needs. For example, each department has a single-line budget and, within limits, can allocate its funds as it sees fit. If a department wanted to put support staff on nine-month instead of twelve-month appointments and convert the savings to computing, for example, it could do so. With flexibility, units have the capacity to reallocate resources consistent with their own expenditure priorities.

While the strictly financial repercussions of the MOU are impressive, the associated changes in focus and style of management afforded by this discretion are even more significant. Institutions can take a longer-term perspective on their operation and focus less on the yearly budget cycle. Because institutions have greater control over the non-state portions of their budget, they can more confidently make multi-year budget commitments. Further, with the removal of the line-item constraints, the capacity to reallocate resources in line with program priorities is enhanced. Through financial flexibility, the university has been able to establish pools of discretionary funds that have been used to invest in new program initiatives.

The university is now able to invest in its future in a way it could not have done under prior spending-control arrangements.

As the University of Colorado implemented financial flexibility, it has chosen to budget conservatively to insure adequate operating funds and avoid any overall deficit. It achieved this by a conservative estimate of revenues and the establishment of reserves to cover contingencies such as shortfalls in tuition revenues, changes in state appropriations, variations in utilities costs, or underrealized earnings. These reserves provide an important smoothing function in the face of uncertainty.

For example, last year the governor pulled back funds mid-year from all of higher education. With its reserves, the university was able to address that loss of funding without disrupting operations. Reserves can also be used to support academic initiatives. We've been able to put new funding into telecommunications, space sciences, neurosciences, computer sciences, undergraduate computing, student writing programs, and the humanities. As a result, departments and faculty with good ideas can come forward and obtain program enhancement money. We have numerous examples of how that's made a very positive difference.

The opportunity to reallocate resources and to use non-state funds for program development has been the most significant consequence of the MOU. The university is now able to invest in its future in a way it could not have done under prior spending-control arrangements.

A Mixed Model

As Tom Tancredo emphasized, the MOU has not meant that the state has totally withdrawn from its involvement with the internal affairs of institutions. A recent study by Frederick Volkwein at SUNY-Albany makes clear that, with MOU, Colorado went from a state with a high degree of centralized control to one with a middle degree of control. The most significant area of continuing state impact is that higher education is still part of the state personnel system. Nearly half our employees—everyone except top administrators and the faculty—have their wage levels and wage increases determined by the state and not the university. The difficult aspect of this system is that the state is not obliged to fund the salary increases that it mandates.

Other forms of control continue as well. The state auditing function operates as before, using the same formats with the same level of detail, so the legislature can look at budget decisions, track reallocations, and see how the money is spent. We still have a state purchasing system, with ceilings and limits imposed. There are limits on the number of faculty and administrative personnel we can employ. On the student side, we have an FTE cap at the Boulder campus. The coordinating council continues to review and approve new program proposals.

The existing Colorado model, then, is far from complete decentralization.

The Disadvantages

One major problem stems from a circumstance just mentioned—the state can impose pay increases for classified staff without having to pay for them. Recent increases in our state appropriations have just covered the mandated salary increases. This has put pressure on all other sources of income, especially tuition.

As a result, institutions in the state have raised tuition more than the legislature would have in the past. Legislators view the process as a trade-off between tuition and faculty salaries, as do the institutions. However, given the long-standing erosion in faculty salaries that we had experienced and its impact on our capacity to be a quality institution, we make this trade-off in a different way and more in support of faculty than did the legislature.

MOU also affects how we set tuition. The president of the University of Colorado has wanted to keep resident undergraduate tuition as low as possible, given our philosophical commitments to access. This makes the pressure more intense to raise out-of-state tuition, which presently accounts for about two-thirds of all tuition revenue on the Boulder campus.

Colorado State University, I might mention, has chosen a less conservative path than ours and now, for the first time, charges more for in-state students (tuition, fees, room and board) than does the University of Colorado. The whole issue of tuition is very sensitive, and is an unstable element in the picture.

A second problem is that the MOU ascribes an average per student appropriation based on support levels established at the time the MOU was introduced three years ago that is carried forward each year with a percentage increase on an across-the-board basis. With adjustments only for changes in FTE student levels, each year the institution is allocat-

ed only that part of the pie allotted when the formula was set. There is no recognition that a given institution's mission or portfolio or programs may have changed. The financial incentive, as such, would be to offer more lower-division, less-expensive programs. If the institution's mission, student needs, or the state's economy press you into greater emphasis on science, technology, and computers, for example, you pursue such programming without the recognition and support of the state government. The MOU formula is frozen and does not contain a mechanism for responding to changes in what is being funded.

A third, continuing problem has to do with political instability surrounding continuance of the MOU. Each year the MOU has to be renegotiated between the institutional governing boards and the Joint Budget Committee of the legislature. While the institutions have planned their operations and budgets on the assumption that the agreement will be renewed, the membership of the committee often shifts, so there are no guarantees. It is difficult to manage an institution, especially for the long run, when you always know that the rules of the game could change just as suddenly and dramatically as they did in 1981 with the introduction of the MOU.

Summing Up

In general, the institutions in Colorado are very supportive of this change in the relationship between higher education and state government. But there are differences in their degrees of enthusiasm, stemming in part from their different degrees of reliance on state and non-state sources of funding. At my university, for example, which has less reliance on state support and more reliance on other funding sources, the MOU has had a most significant impact since it gave no control over the non-state resources that are so important to us.

Enthusiasm also varies with the willingness and capacity of institutions to exert leadership and pursue aggressively the potential benefits of flexibility. In Colorado, there has been a decided range of responses to this opportunity.

Finally, financial flexibility is but a tool, not an end in itself. The quality of an institution is determined by a surrounding fabric of faculty effort, the focus of academic programs, the effectiveness of personnel systems, the quality of departmental leadership, and the ability and motivation of students. Financial flexibility as a *process* puts in the hands of university leadership many of the tools necessary to achieve greater effectiveness in public higher education.

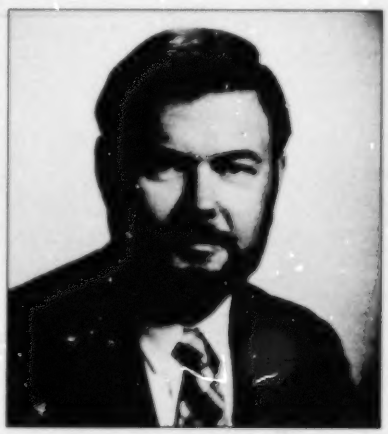
3. Lessons from Colorado

by Patrick M. Callan

My reactions to the Colorado experiment are these. At the moment we have too much rigidity and too much bureaucracy in higher education, both imposed upon the education community from above and from within, so at this point in our history we ought to be making our mistakes on the side of greater flexibility and freedom. I am not as uncritical a champion of the marketplace as Mr. Tancredo. I have reservations about the Colorado approach, but I think it raises issues that have needed airing for some time in most states.

The first thing about the Colorado experiment is that it's simply not possible in a year or two to evaluate either its stability or its success. In the short term, it's hard to make much of the first stirrings of very complex institutions in the face of a very complex set of incentives and disincentives. What we need to watch closely over time is whether the public's goals of access and quality and effective management are enhanced. Legislators, boards, and institutions have to create mechanisms of governance, finance, and accountability that achieve these public goals. The test isn't whether this party or that likes the system, or whose prerogatives are served, but whether the broader needs of the citizens of the state are met by the totality of institutional responses to a given set of incentives. In Colorado, the jury has to remain out on this matter.

I think the leadership of public higher education in this country has been woefully slow to seize on the possibilities inherent in the anti-bureaucratic, anti-government, anti-red-tape mood of the public. Public authority has often tied higher institutions up in knots, yet hardly a word of protest or specific counter-measures are heard. Public policy is often vague about whether institutions should focus on growth, quality, access, certain programs, or whatever. Incentives are laid out without careful analysis, and when a behavior is noticed that isn't liked, the incentive isn't reassessed; instead, a new regulation is imposed on top of it. Public higher institutions, on the other hand, when they argue for greater flexibility, often don't back it up with a hard-nosed analysis of how management or quality or effectiveness will improve as a result. Legislators see institutional administrators as expecting simple deference,



Pat Callan has directed the California Postsecondary Education Commission since 1978. Before then, he was executive coordinator of the Council for Postsecondary Education in the State of Washington, and led statewide studies in Montana and California. During the past year, he served as president of the State Higher Education Executive Officers Association.

perhaps because of assumed intellectual or moral superiority, and an exemption from the processes all other entities of the state submit to. Maybe the Colorado experiment can help people in other states see ways out of these binds.

It's not just that institutions haven't made a better case for autonomy. They undermine that case in state after state with multicampus systems when they argue for flexibility for the governing board or central staff but then fail to apply that logic to the campus level and to units below. Everyone seems to believe that the system functions rationally up to their own level, but above that level you have all kinds of clumsy, interfering, insensitive people and systems. One of the attractive aspects of the Colorado approach as it was implemented in the University of Colorado is that state decentralization was tied to campus decentralization and more decision-making really did become local.

Observing Colorado

There are a few observations specific to Colorado that I would venture at this time.

The first is that Colorado's change is so "revolutionary" because Colorado started off so far behind most other states. Educators in other states may think they are overcontrolled, but Colorado's former system was the epitome of rigidity and control.

On the positive side, the reduction in line items and the flexibility for internal transfer of funds are such logical and sensible steps that every state that hasn't looked at the matter needs to do so. The ability to carry forward earned and unexpended funds, and the incentive that ability brings for long-term management, is also quite important. My one hesitation on the latter score would be that if institutions accumulate significant surpluses they may become more visible targets for mid-fiscal-year reductions.

I have more concerns about letting tuitions float. I sense this is a matter of how confident one is of market forces to produce good results and of how heavily one weighs equity considerations for students. I'm uneasy about allowing individual institutions to set tuition solely on the basis of what the market will bear. Shouldn't there be some relationship in tax-supported institutions between what students pay for some level of service from one place to the next? I don't mean that all prices need to be the same, but some element other than short-term institutional self-interest should enter the picture.

Educators in other states may think they are overcontrolled, but Colorado's former system was the epitome of rigidity and control.

To press this point, there are public institutions in both Colorado and California that have so much student demand that they could charge what their private counterparts do and still fill their student bodies. But, what would be the change in the socio-economic composition of their student bodies? Would that change be in the public interest?

I have the same concern about proposals to charge different tuition by level or discipline, especially at the undergraduate level. At some point, with each institution going off in its own direction, the fee system grows so complex and independently driven that the state may be unable or unwilling to meet the resulting obligations for student aid. Some state oversight of tuition and aid policies is probably inevitable.

Tuition policy is potentially the most volatile aspect of deregulation. I know it is tempting to legislators to think that now students and parents will bring tuition-hike complaints elsewhere for a change, to some board or institution, but I doubt it will stay that way for long. The complaints will come back to the seat of ultimate power, and will surely test the new arrangement.

Two other points raised by Marilyn McCoy strike me as weak spots in the MOU: (1) using as a funding base an average-cost approach and then (2) freezing the formula based on an historical figure. This is punitive to many institutions, especially smaller or newer ones that don't start out with a favored geographic or program base. And what of the institution that loses enrollment, perhaps for reasons far from its own control? Is it realistic to reduce funding on the simple basis of our average cost per student? Most studies suggest that it is not. I think there is a public interest in recognizing individual situations and in funding some institutions on special bases.

Final Thoughts

Those who put the MOU together in Colorado are to be congratulated, not only for their programmatic accomplishment but for forcing us all to confront new issues.

To observe that the Colorado experiment is a mixed model—with some aspects of flexibility and some of control—is not to denigrate it in the least. The issue isn't whether decentralization *per se* is good or bad, or how benign you think market forces are, but whether this new system has the mix of incentives that, over the long run, produces institutional responses that serve enduring public interests.

Colorado's system, like any other political arrangement, will survive to the degree that it elicits confidence and trust. This means that higher education's leaders, top legislators, the governor, and the state budget office alike have to believe that the system is fair and that it works. Therefore, all parties, before they complain about a given behavior and start talking about new controls, should take a hard look at the system's incentives and disincentives. That's where the problem, if it is one, probably began.

Finally, the greatest loss of flexibility to institutional managers in recent years has not come from intrusive state controls of an insensitive bureaucracy. The greatest loss of flexibility has come from inadequate funding. If you keep having dollars taken away from you, there's less and less flexibility in your situation. As a California president told a budget hearing in Sacramento recently, "Don't send flexibility; send money." So it will be important in any state's analysis of its situation to separate the problems we have because of tough times from those we have because of over-regulation. ■